MiFID 2 for Custodians

Introduction

Collateral

Treatment of Assets

Reporting to Clients

Introduction

The investor protection measures introduced by the revised Markets in Financial Instruments Directive (MIFID 2) will also impact custodians and firms holding client assets. The European Securities and Markets Authority (ESMA) in its Technical Advice to the Commission on MiFID 2 and MiFIR (ESMA Technical Advice) has also proposed a number of Level 2 measures which, if implemented, will increase the regulatory burden for such firms.

This briefing note provides a short introduction to some of those measures and analyses their impact for UK firms particularly in light of the current client assets rules of the Financial Conduct Authority (FCA).

Collateral

Title Transfer Collateral Arrangements

MiFID 1 required firms holding financial instruments belonging to clients to safeguard their clients' ownership rights and prohibited the firm from using those financial instruments except with the client's express consent.

There has long been concern about the use of title transfer financial collateral arrangements i.e. an arrangement where a person transfers full ownership of financial instruments or cash to secure an obligation (TTCAs). This is because assets subject to a TTCA no longer benefit from the safeguarding protections granted under MiFID and the risk to the client on the failure of the investment firm is, therefore, significantly increased because the client has only a contractual claim for the return of the investments (subject to the availability of netting provisions).

MiFID 2 introduces a further restriction and prohibits firms from entering into TTCAs with retail clients. This will introduce a blanket ban on TTCAs with retail clients in contrast to the FCA's current position where TTCAs are generally permitted with retail clients (except in the case of certain contracts for difference or forex futures contracts) subject to disclosure requirements.

The ESMA Technical Advice proposes that for professional clients, firms must not conclude TTCAs without proper consideration and should consider (and be able to demonstrate) that they have properly considered the use of a TTCA in the context of both the obligation of the client and the use of the relevant assets. In other words, a firm will need to ensure that the use and scope of the TTCA is appropriate and proportionate in the circumstances.

ESMA suggests that a TTCA would not be appropriate in the following circumstances:

- there is only a very weak connection between the client's obligation to the firm and the use of TTCAs, including where the likelihood of a liability arising is low or negligible;
- the amount of client funds or financial instruments subject to TTCAs far exceeds the client's obligation, or is even unlimited if the client has any obligation at all to the firm; or

- a firm insists that all client assets must be subject to a TTCA, without considering the client's obligation to the firm.

Therefore, firms dealing with professional clients will need to review their TTCA arrangements and consider whether these would be considered appropriate and proportionate given the obligation owed by the client to the firm. In most circumstances, a standard form provision requiring all client assets to be subject to a TTCA which is applied indiscriminately to all clients would not be permitted. It is likely that firms would have to monitor on a regular basis the scope of assets subject to a TTCA at any one time and the amount of the client's obligation to the firm and release any excess assets from the scope of the TTCA where required.

Security Interests

ESMA also proposes a ban on firms entering into arrangements granting a third party the right to a security interest, lien or right of set-off over client assets that do not relate to the particular client or the services provided to it unless required by applicable law. If a firm is required to enter into such arrangements by applicable law then these arrangements must be disclosed to the relevant clients so that they are aware of the associated risks.

This will be particularly relevant for sub-custody arrangements and relationships with securities depositories.

It remains to be seen how this will affect the FCA's current position which is to permit such rights over financial instruments only in certain limited circumstances such as in respect of properly incurred charges and liabilities arising from the provision of custody services or where the interest arises under the operating terms of a securities depository, securities settlement system or central counterparty for the purpose only of facilitating the settlement of trades involving the assets held in that account. A further situation where such a right may be permitted is where the financial instruments are held outside the UK and such a right is as a result of applicable law or is necessary for the firm to gain access to the local market in that jurisdiction. It seems likely that post-MiFID 2 this will be amended so that such rights are no longer permitted where the sole justification for granting these is to gain access to the local market.

It is also not clear how this will affect omnibus accounts where a security interest, lien or right of set-off relates to some but not all of the clients holding assets in that account. On the face of it, it would seem that it could be prohibited.

Treatment of Assets

Diversification of Funds

Where a firm holds client money with a third party then ESMA recommends that as part of its due diligence in selecting, appointing and periodically reviewing that third party, the firm should consider whether it is appropriate to diversify those funds, i.e. hold them with a number of different third parties.

In addition, no more than 20 per cent of client money should be held with an affiliate (unless the firm can demonstrate that the requirement is not proportionate given the nature, scale and complexity of its business, the safety offered by the affiliate and the amount of client money held by the firm).

This requirement to diversify is broadly equivalent to the current diversification requirement in the FCA's client assets rules.

Segregation

Under MiFID 1 firms must take the necessary steps to ensure that any client financial instruments deposited with a third party are identifiable separately from the firm's proprietary assets and those belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection. Firms must also take the necessary steps to ensure that client money deposited in a bank, a credit institution or qualifying money market fund are held in an account or accounts identified separately from any accounts holding money belonging to the firm.

Where it is not possible to comply with the above requirements as a result of the applicable law of the jurisdiction in which the client money or assets are held then member states are

permitted to prescribe requirements which have an equivalent effect in terms of safeguarding clients' rights.

ESMA has said that this provision should be interpreted strictly and firms should only be able to rely on equivalent measures where they are unable to comply with the segregation requirements due to applicable law. In other words, this would not apply where the inability to comply was solely due to market practice.

Currently the FCA in its client assets rules does not suggest any particular measures which it considers would have an equivalent effect in terms of safeguarding clients' rights preferring instead to repeat the wording "or other equivalent measures that achieve the same level of protection" but the effect of MiFID 2 will be to limit the scope of this further.

Reporting to Clients

The ESMA Technical Advice proposes that firms should provide statements to clients on their client assets on a quarterly basis at a minimum rather than at least annually as is the current requirement. Firms must also provide statements more frequently on request at reasonable commercial cost.

ESMA also proposes extending the contents requirements of those statements requiring firms to provide:

- a clear indication of the assets or funds which are subject to MiFID protections and those that are not, such as those that are subject to TTCA;
- a clear indication of which assets are affected by some peculiarities in their ownership status, for instance due to some security interest; and
- the market value or, if not available, the estimated value (on a best effort basis).

From a UK perspective, the requirement to indicate which assets and funds are subject to MiFID protections and which are not goes beyond the current requirement in the FCA's client assets rules to inform retail clients which assets are subject to collateral arrangements as it will apply more widely than just to collateral arrangements (although that is where it is likely to have the main impact) and to professional clients as well as retail clients.

Also the requirement to indicate which assets are subject to a peculiarity in ownership status is likely to be a significant burden for firms. This will require a more in-depth analysis of the impact of security and set-off arrangements, which are often expressed in general terms, including rights which arise under general law rather than as a contractual provision. It may also require firms to consider the impact of foreign law where assets are held outside the UK, for example, under an overseas sub-custody arrangement.

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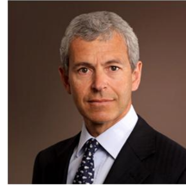

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